Blackstone's Real Estate Investment Choices

Introduction

It was recently announced that Blackstone will acquire BioMed Realty Trust (ticker BMR) as a part of its Blackstone Real Estate Partners VII. Per the estimate in the article[1], Blackstone still has around $28B to place. I will make an argument that a publicly traded REIT that owns the majority of its properties in New York City should be an acquisitions target.

New York Office Pricing

An article in The Real Deal[2] cited Green Street's Midtown Manhattan Office Price Index and provided the following chart of the index which shows a steady upward climb in prices in the past year resulting in a 4% year-over-year increase in prices.

[1] http://www.costar.com/News/Article/What-Is-Blackstone-Going-To-Buy-with-its-Latest-$158-Billion-Real-Estate-Fund-/176085

[2] http://therealdeal.com/blog/2015/10/07/debt-market-sovereign-wealth-softening-yet-to-impact-manhattan-market-report/

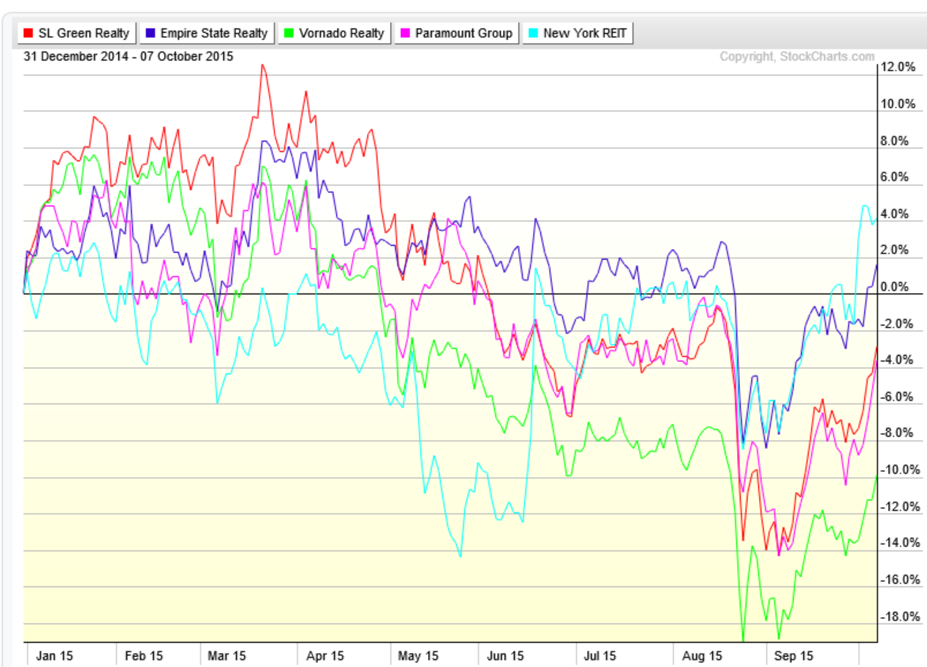
Public REITs with New York City Concentration

There are numerous public REITs that own the majority of their properties in and around New York City (NYC REITs) which are shown below along with an estimate of the concentration of their portfolio that is located in New York City, their implied cash cap rate, and an estimate of the total real estate assets the REIT owns.

Blackstone Potential Public REIT Acquistion Targets				
REIT Name	Ticker	NYC concentration	implied cash Cap Rate	Real Estate Assets (B)
SL Green	SLG	100%	4.90%	23,877
Empire State Realty Trust	ESRT	100%	5.80%	6,417
New York Realty Trust	NYRT	100%	4.81%	3,024
Paramount Group	PGRE	79%	5.49%	7,024
Vornado	VNO	69%	5.56%	31,972

NYC REITs 2015 Returns

The total return on the equity of each NYC REIT in 2015 is charted below. It is quite clear that the equity returns of these REITs did not imply that the market thought the value of their properties had been steadily increasing throughout the year. In addition, each of these REITs generated income over the course of the year which is incorporated into the total equity return so the price component of return for these REITs would be worse than the total return shown. It does not require extensive analysis to perform an "apples to apples" comparison between the Green Street data and the REIT equity performance to show that Manhattan office prices have been increasing in 2015 while REITs whose portfolios consist of a significant amount of Midtown Manhattan office buildings have performed poorly. Herein lies the investment opportunity.



Comparing Public to Private Real Estate Acquisitions

Blackstone is a very sophisticated real estate investor and has shown that it is as comfortable acquiring a publicly traded REIT such as it recently did with BMR and has done in the past with Equity Office and Hilton as it is with purchasing either individual buildings or portfolios of buildings. As such, Blackstone needs to be able to use a valuation metric that allows for the comparison between publicly traded REITs and privately owned real estate or a portfolio of privately owned real estate. For privately owned real estate the one most used valuation metric is the cash capitalization rate which is defined as the cash net operating income in the forward looking 12 months divided by the purchase price. A similar metric can be estimated for a publicly traded REIT to facilitate an "apples to apples" comparison between publicly traded REITs and privately owned real estate.

REIT Market Implied Capitalization Rate

To calculate a REIT's market implied cash capitalization rate, an estimate of the cash NOI generated by the REIT's properties in the next 12 months needs to be made. To do this, the cash NOI generated in the previous 12 months can be calculated then projected forward for the next 12 months. For properties wholly owned by the REIT, calculating the historical GAAP NOI is straight forward as property level income and expenses are provided but for partially owned properties that are either fully consolidated or non-consolidated on the balance sheet this can become less straight forward so adjustments need to be made.

Once the backwards looking GAAP NOI has been calculated, the straight line rent adjustment can be used to convert from GAAP NOI to cash NOI. From here assumptions can be made to project the cash NOI into the future. Finally adjustments need to be made for any acquisitions or dispositions that the REIT has made in the previous year.

The calculation of what the market thinks a REIT's assets are worth is a much more straight forward calculation as it is the sum of the marked to market value of a REIT's equity and liabilities. I prefer to back out a REIT's non-income generating assets such as land and developments in progress at cost along with cash as I believe this gives a more precise calculation of the REIT's implied capitalization rate.

ESRT Market Implied Capitalization Rate

As it should be clear, calculating a REIT's implied capitalization rate is not matter of adjusting several GAAP reported numbers but instead requires one to dig into the REIT's financials and make reasonable assumptions. Nevertheless, the assumptions are a relatively small part of this calculation and competent analysts should be able to arrive at similar implied cap rates. The calculation of ESRT's implied rate is shown below as it is the straightest forward of the REITs with a concentration in New York City.

ESRT Implied Cap Rate Calculation

common shares outstanding (m)	114.25
OP Units (m)	153.33
Total common shares/OPP units (m)	267.59
share price	17.67
market capitalization including OPP units (m)	4,728
Liquidation Value of Preferred Shares	25.9
Total Consolidated Debt	1,633
Total Consolidated Market Capitlization	6,388
JV Partners' share of consolidated debt	-
pro-rata share of unconsolidated JV	-
Total adjusted debt	1,633
Total Adjusted Market Capitalization (m)	6,387.59
Total adjusted market cap plus pro-rata share of unconsolid	6,387.59
Cash Balance 2Q15	34.2
Total Adjusted market cap plus pro-rata share of unconsolid	6,353.37
Non income producing assets	-
Total income producing assets	6,353.37
Total adjusted debt + preferred shares / total adjusted mark	26.0%

Non income producing assets	
none	-
	-
	-
Total non-income producing assets	-

ESRT same store NOI Growth 2Q15 vs 2Q14		Net of Occ.
GAAP	2.7%	3.0%
Cash	19.3%	19.7%
Occupancy T6M	88.4%	
Occupancy year ago T6M	88.6%	
Occupancy Change	-0.2%	

	3Q13	4Q13	1Q14	2Q14	2Q14 TTM	3Q14	4Q14	1Q15	2Q15	2Q15 TTM	Annual Growth	Pro-Forma	Growth
Property operating revenue			124.7	140.4	530.4	163.1	165.0	149.8	163.8	641.8	21.0%	693.09	8.0%
Property operating expenses			61.7	60.9	245.1	69.3	75.7	74.7	70.6	290.4	18.5%	296.18	2.0%
Property NOI	0.0	0.0	63.1	79.5	285.2	93.7	89.4	75.1	93.2	351.4	23.2%	396.92	
NOI from discontinued operations					0.0					0.0	0.0%		
Partners' share of consolidated JV					-					-		-	
NOI from unconsolidated JVs					0.0					0.0		-	0.0%
Investment income					0.0					0.0		-	0.0%
Other income					0.0					0.0		-	0.0%
G&A Expense			-10.2	-9.6	(39.4)	-10.1	-9.3	-9.1	-9.1	-37.5	-4.8%	(38.66)	3.0%
As % of EV										0.59%		0.61%	
Total GAAP NOI	-	-	52.9	70.0	245.8	83.7	80.1	66.0	84.1	313.8	27.7%	358.3	14.1%
Implied Cap with G&A										4.94%		5.64%	
Implied Cap without G&A										5.53%		6.25%	
Straight Line Rent Adjustment			-12.6	-11.0	-47.1	-8.5	-7.6	-4.1	-5.6	(25.88)		(26.40)	2.0%
Total Straight Line NOI			40.3	59.0	198.7	75.1	72.5	61.9	78.4	287.97		331.86	-7.4%
Implied Cap with G&A												5.22%	
Implied Cap without G&A												5.83%	
											average		
Cash BI and TI			20.1	30.3	100.8	32.3	38.6	27.7	34.3	132.9			
BI and TI as % of EV					1.6%					2.1%	1.8%		
NCREIF historical											1.5%		

Acquisitions/Disposition

Property	Acq/Dis	Date	Price (M)	Adjustement to model
112 West 34th St. and 1400 Broad	Acq	15-Jul-14	734	None needed as acquisition only 15 days into TTM

NYC REITs' Implied Capitalization Rates

The table below shows all of the implied cash NOI capitalization rates for publicly traded REITs that own the majority of their properties in New York.

Blackstone Potential Public REIT Acquistion Targets

REIT Name	Ticker	NYC concentration	implied cash Cap Rate	Real Estate Assets (B)	with 15% premium (B)
SL Green	SLG	100%	4.90%	23,877	27,458
Empire State Realty Trust	ESRT	100%	5.80%	6,417	7,380
New York Realty Trust	NYRT	100%	4.81%	3,024	3,478
Paramount Group	PGRE	79%	5.49%	7,024	8,077
Vornado	VNO	69%	5.56%	31,972	36,768

New York City Office Property Comparables

SLG acquired 11 Madison Avenue[3] and disposed of Tower 45 and 120 West 45th Street[4] in 2015. Per the 11 Madison Avenue article, Omotayo Okusanya of Jefferies calculated a cash cap rate of 4.60% and SL Green calculated a blended capitalization rate of 3.3% for the Tower 45 and 120 West 45th Street sale. While these are only three comparable sales, it should be quite clear that these sales happened at much lower capitalization rates than the implied capitalization rates of the NYC REITs.

Low Barrier to Entry Market Comparables

The following table summarizes recent acquisitions that Highwoods (ticker HIW) made in Atlanta and Tampa. The purchases were straight forward as their press release[5] gave all of the pertinent information to calculate the cap rate of their purchase and it is summarized below.

Summary of Highwood's Acquisitions			
	Monarch Center	Suntrust Financial	Total
purchase price	303,000,000	124,000,000	427,000,000
year 1 cash NOI excluding free rent	13,000,000	8,000,000	21,000,000
year 1 cash NOI including free rent	10,700,000	7,500,000	18,200,000
cap rate on cash NOI excluding free rent	4.29%	6.45%	4.92%
cap rate on cash NOI including free rent	3.53%	6.05%	4.26%

The following table summarizes recent acquisitions made by Parkway Properties (ticker PKY). It should be noted that these acquisitions all occurred in 2014 and because the Green Street property has increased since, it is likely that these cap rates have likely compressed.

Parkway Acquisitions				
Building	**Market**	**Purchase Price**	**Stated Cap Rate**	**Announcement Date**
One Buckhead Plaza	Atlanta	157,000,000	5.50%	30-Oct-14
Corporate Center I,II,III	Atlanta	475,000,000	5.85%	22-Sep-14
Courvoisier Centre	Miami	145,800,000	4.50%	10-Apr-14
BofA Center	Orlando	52,500,000	6.30%	6-Jan-14
JTB Center	Jacksonville	33,300,000	8.30%	6-Jan-14
Total		**863,600,000**	**5.68%**	

What these comparable sales show is that properties located in low barrier to entry markets are being priced at capitalization rates that are similar to and often lower than the implied capitalization rates of NYC REITs.

[3] http://www.streetinsider.com/Analyst+Comments/Jefferies+Says+11+Madison+Avenue+Purchase+is+A+Nice+Get+for+SL+Green+Realty+%28SLG%29+and+Reiterates+Buy/10581543.html
[4] http://investor.shareholder.com/slg/releasedetail.cfm?ReleaseID=921758
[5] http://www.highwoods.com/Investor/Enhanced-BBD-Office-Focus-Presentation.pdf

REIT NAV Premium/Discount

Quoted from this article[6]:

> There's a gaping hole between the net asset values and stock prices for much of the REIT sector - “a disconnect and that creates opportunities for us," Blackstone’s Gray said last week at a conference sponsored by the Pension Real Estate Association in San Francisco.
>
> And according to research from REIT mutual fund giant Cohen & Steers, nowhere is that REIT valuation disconnect more apparent than in offices and hotels, where valuations are at attractive levels relative to their four-year average range.
>
> Hotel REITs are trading at a -13.2% premium/discount to net asset values and office REITs are trading at a -16.3% discount, both are at the bottom of their four-year ranges.

Pricing

We can see from Blackstone’s purchase of BMR that they paid a 24% premium to BMR’s stock price the day prior to the announcement. This does not mean that they paid a 24% premium over where the market was valuing their assets. The August, 2015 edition of NAREIT’s REITWatch shows BMR as having a 38.0% debt ratio. Therefore they paid a 15% premium over where the market had valued BMR’s assets as opposed to their equity. For comparison purposes, the difference between paying a 4.0% capitalization rate and a 5.5% capitalization rate is 37.5%. Therefore if Blackstone thinks that commercial office properties should be selling in NYC for a 4.0% capitalization rate, they could buy PGRE and all of its assets for 15% over their current market valuation and still get the properties for 20% less than they think the properties would sell for in a private transaction.

Size

We can calculate what the market implies the size of each of the NYC REITs is then estimate the total size of the potential acquisition if a 15% premium were paid. We see that 3 of the NYC REITs are similar in size or smaller than the BMR acquisition with SLG and VNO being much larger although SLG is still within the $28B Blackstone has still to place.

Blackstone Potential Public REIT Acquistion Targets

REIT Name	Ticker	NYC concentration	implied cash Cap Rate	Real Estate Assets (B)	with 15% premium (B)
SL Green	SLG	100%	4.90%	23,877	27,458
Empire State Realty Trust	ESRT	100%	5.80%	6,417	7,380
New York Realty Trust	NYRT	100%	4.81%	3,024	3,478
Paramount Group	PGRE	79%	5.49%	7,024	8,077
Vornado	VNO	69%	5.56%	31,972	36,768

[6] http://www.costar.com/News/Article/What-Is-Blackstone-Going-To-Buy-with-its-Latest-$158-Billion-Real-Estate-Fund-/176085

Conclusion

Blackstone is a very sophisticated real estate investor. They have historically acquired numerous property types in different ways including through private transitions and the buyout of public REITs. Therefore they are unconstrained by asset type, whether the real estate is acquired through a private sale or through the acquisition of a public REIT, and due to their size, are generally not constrained by the size of the investment.

For the following reasons, I think Blackstone should acquire a NYC REIT:

- Office Properties in NYC have been increasing in price in 2015 while NYC REITs have had a significant fall off in price
- NYC REITs are selling at much higher implied cap rates than private office sales
- Office properties in low barrier to entry markets are selling at capitalization rates that are similar to or lower than the implied capitalization rates of NYC REITs
- Office REITs are trading at a significant discount to their NAV
- The current pricing of NYC REITs allows Blackstone to pay a takeover premium and still have a basis at a significant discount to what office prices in NYC are selling for
- 4 of the 5 NYC REITs could potentially be acquired for less than Blackstone still has to place

Mr. Bollinger is the founder and CEO of Magnolia Realty Advisors. Prior to founding Magnolia, he was an analyst at KBS Realty Advisors in Atlanta, GA for 5 years where he worked on a 2 person asset management team overseeing a $500M portfolio of commercial real estate. Prior to KBS, Mr. Bollinger worked in the CMBS industry in New York City as a consultant for 3 years supporting clients such as Merrill Lynch and Bear Stearns. He earned an MBA from Vanderbilt University and a BS in Industrial Engineering from Virginia Tech.